CHAPTER 3

MAKE THE SYSTEM MORE NEUTRAL AND FAIR

Part A. Excluded Sources of Income--Fringe Benefits

An employee is generally required to include in gross income all compensation received during the year from his or her employer, regardless of whether the compensation is paid in cash or in property or other in-kind benefits. Current law, however, exempts from taxation certain employer-provided in-kind benefits, such as the cost of group-term life insurance (up to $50,000), educational assistance, accident and health insurance, group legal services, and dependent care assistance. These and certain other fringe benefits are expressly excluded from an employee's taxable income if provided under qualified employer-sponsored plans.

Compensation paid in the form of in-kind benefits is not different in principle from compensation paid directly in cash. The employee who receives fringe benefits is not in a different pre-tax economic position than the employee who receives cash compensation and uses it to purchase the same benefits. The exclusion of certain fringe benefits from income under current law is thus unrelated to the proper measurement of income. It is intended instead to reduce the after-tax cost of certain goods or services and thereby to subsidize consumption of such items by eligible taxpayers.

The exclusion of fringe benefits from income has economic and social costs that have not always been reflected in political debate over fringe benefit tax policy or in individuals' expressed judgments about the desirability of maintaining existing tax preferences for fringe benefits. The incentive for consumption of fringe benefits created by their exemption from tax may overstimulate demand, producing losses in efficiency and artificially high prices. Nontaxation of fringe benefits also raises significant fairness concerns, since nontaxable benefits are not available to all taxpayers and are of greater value to high-bracket taxpayers. Finally, and most importantly, the exclusion of fringe benefits from income loses significant tax revenue, thus causing tax rates to be higher than they would be if fringe benefits were taxable.

The costs entailed in excluding fringe benefits from the tax base may be justified to the extent employer provision of fringe benefits serves significant social policy objectives that might otherwise fall to government and government-funded programs. This rationale for the nontaxation of fringe benefits requires, however, that the availability of an income exclusion be conditioned on the provision of fringe benefits on a broad, nondiscriminatory basis. It suggests as well that fringe benefits be excluded from income only where they directly and significantly enhance employee health and security.

INCLUDE IN INCOME A LIMITED AMOUNT OF EMPLOYER-PROVIDED HEALTH INSURANCE

General Explanation

Chapter 3.01

Current Law

All employer contributions to health insurance plans on behalf of an employee are excluded from the employee's gross income, regardless of the cost or extent of the coverage. The same rule generally applies to amounts paid by an employer to or on behalf of an employee under a self-insured medical plan.

Although medical expense reimbursements under a self-insured plan must be provided on a nondiscriminatory basis to be excludable, similar benefits provided through an outside insurer are not subject to nondiscrimination rules.

Reasons for Change

The exclusion of employer-provided health insurance from income subsidizes the cost of such insurance for eligible taxpayers. Although this tax-based incentive for employee health insurance is an appropriate part of the national policy to encourage essential health care services, in its present form, the exclusion contributes substantially to horizontal inequity and to higher than necessary marginal tax rates.

The exclusion from income of employer-provided health insurance is unfair to individuals who are not covered by employer plans and who must therefore pay for their health care with after-tax dollars. Table 1 illustrates the impact of the exclusion on two employees each of whose compensation costs his respective employer $35,000. Individual A receives $2,400 of his compensation in the form of employer-provided health insurance; Individual B receives all of his compensation in cash. As shown in the table, A's after-tax income is $809 higher than B's simply because some of his compensation is in the form of health insurance. B must pay for any medical expenses or privately purchased insurance out of his lower after-tax earnings.

The exclusion for employer-provided health care has also contributed to the erosion of the tax base and to consequent high marginal tax rates, especially as employer-provided health care has become increasingly widespread. Imposing a limited tax on employer-provided health care would help broaden the base of taxable income and thus reduce marginal tax rates without jeopardizing the national policy of encouraging essential health care services.

Table 3.01-1

Tax Benefits Arising from the Exclusion of Employer-Provided Health Insurance 1/

	Individual A	Individual B
Total Employer Cost	$35,000	$35,000
Non-Taxable Employer-Provided Health Insurance	2,400	---
Employer Social Security Tax	2,147	2,305
Cash Wages	30,453	32,695
Employee Income Tax	2,996	3,489
Employee Social Security Tax	2,147	2,305
After-Tax Income Plus Value of Health Insurance	**27,710**	**26,901**
Cost of $2,400 of Health Insurance	1,591	2,400

Office of the Secretary of the Treasury May 28, 1985

1/ 1985 tax rates for a family of four with no other income and with itemized deductions equal to 23 percent of adjusted gross income.

In addition, the tax benefits provided for employee health care should not be available on a basis that permits discrimination in favor of owners and high-paid employees. Thus, nondiscrimination rules should apply to employer-provided health benefits regardless of whether such benefits are self-insured or provided through third-party coverage.

Proposal

Employer contributions to a health plan would be included in the employee's gross income up to $10 per month ($120 per year) for individual coverage of an employee, or $25 per month ($300 per year) for family coverage (i.e., coverage that includes the spouse or a dependent of the employee).

With respect to any employee, an employer's contribution to a health plan would be the annual cost of coverage of the employee under the plan reduced by the amount of the employee's contributions for such coverage. The annual cost of coverage with respect to an employee would be calculated by determining the aggregate annual cost of providing coverage for all employees with the same type of coverage (individual or family) as that of the employee, and dividing such amount by the number of such employees.

In most cases, determination of the precise cost of coverage would be unnecessary, because the floor amounts would clearly be exceeded. In those cases where the floor amounts would not necessarily be exceeded, the following method of determining cost would be used.

The annual cost of providing coverage under an insured plan (or any insured part of a plan) would be based on the net premium charged by the insurer for such coverage. The annual cost of providing coverage under a noninsured plan (or any noninsured part of a plan) would be based on the costs incurred with respect to the plan, including administrative costs. In lieu of using actual administrative costs, an employer could treat seven percent of the plan's incurred liability for benefit payments as the administrative costs of the plan. A plan would be a noninsured plan to the extent the risk under the plan is not shifted from the employer to an unrelated third party.

The cost of coverage would be determined separately for each separate plan of the employer. Coverage of a group of employees would be considered a separate plan if such coverage differs in a significant manner from the coverage of another group of employees.

The proposal would require that the cost of coverage under the plan be determined in advance of the payroll period. The cost would be redetermined at least once every 12 months, and whenever there are significant changes in the plan's coverage or in the composition of the group of covered employees.

If the actual cost of coverage cannot be determined in advance, reasonable estimates of the cost of coverage would be used. If an estimated cost were determined not to be reasonable, the employer would be liable for the income taxes (at the maximum rate applicable to individuals) and the employment taxes (both the employer's and the employee's share) that would have been paid if the actual cost of coverage had been used. Where an employer makes contributions to a multiemployer plan, the multiemployer plan would be treated as the employer for purposes of determining the cost of coverage and the liability for errors in estimates.

If the cost of coverage fluctuates each year depending on the experience of the employer under the plan, an average annual cost of coverage could be used, based, in appropriate circumstances, on the average cost for the past three years (adjusted to reflect increases in health insurance costs).

Appropriate nondiscrimination rules would be applied to employer-provided health benefits, regardless of whether employer health plans are self-insured or provided through third parties. See Ch. 3.04 for a description of the proposed nondiscrimination rule.

Effective Date

The proposal would apply to employer contributions received in taxable years beginning on or after January 1, 1986.

Analysis

The proposal would reduce the unfair distinction between those with employer-provided health insurance and those who must pay for health insurance with after-tax dollars. In the case illustrated in Table 1, under current law the employee with $2,400 of employer-provided health insurance paid $809 less in taxes than a similar family that purchased $2,400 of health insurance with after-tax dollars. Under the Administration proposal, the difference would fall from $809 to $611. The cost of $2,400 of employer-provided health insurance would rise from $1,591 to $1,789, due partly to the inclusion of $300 of employer contributions in income and partly to the reduction in the marginal tax rate for this family (from 22% to 15%).

The higher amount included in income for family coverage reflects the fact that such coverage is approximately two-and-one-half times as costly as individual coverage.

The proposal would be administratively simple, since almost all those with employer contributions will have such contributions in excess of the proposed includable amounts. Only in those rare cases where the employer's contribution is less than $10 (individual) or $25 (family coverage) per month would estimates of the average cost of health plan coverage be necessary. Moreover, the proposal's implementation need not be delayed, since it should have no major impact on the nature of negotiated contracts.

The distributional impact of this proposal is summarized in Table 2. Less than 20 percent of all employer contributions would be included in income, resulting in additions to taxable income for approximately half of all families. Families with incomes above $30,000 would pay three-quarters of the taxes imposed on employer contributions. Less than 5 percent of the additional tax liability would fall on those with under $15,000 of income. The additional tax liability is concentrated among higher income taxpayers for two reasons. First, as illustrated in the first two columns of Table 2, employer contributions for health insurance are much more common (and larger) for higher income families. Less than 15 percent of families with incomes below $15,000 receive such contributions, compared to over 80 percent of families with incomes over $50,000. Second, the tax rate on the included portion of employer contributions is higher for those with higher incomes. Given the proposed increases in the personal exemption and zero bracket amounts, no families with incomes below the poverty line would pay tax on employer contributions.

Table 3.01-2

Distribution of Employer Contributions for Health Insurance (1983), and Estimated Impact of the Proposal

Family Economic Income	Percent of Families Receiving Employer Contribution	Average Employer Contribution	Percent of Contributions Included in Income Under the Proposal	Distribution of Additional Tax Liability
$ 0 to 9,999	14 %	$ 60	19 %	* %
10,000 to 14,999	34	80	19	4
15,000 to 19,999	46	90	18	6
20,000 to 29,999	60	100	18	16
30,000 to 49,999	76	130	18	34
50,000 to 99,999	86	170	16	34
100,000 to 199,999	81	190	15	6
200,000 or more	76	200	14	*
All Families	56 %	$125	17 %	100 %

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* Less than 0.5 percent.

REPEAL $5,000 EXCLUSION FOR EMPLOYER-PROVIDED DEATH BENEFITS

General Explanation

Chapter 3.02

Current Law

Death benefits paid by an employer to the estate or beneficiaries of a deceased employee are excluded from the recipient's income. The maximum amount that may be excluded from income with respect to any employee is $5,000. Accordingly, an allocation of this exclusion is required if multiple beneficiaries receive, in the aggregate, more than $5,000. Except with respect to certain distributions from or under qualified plans, the exclusion does not apply to self-employed individuals.

In addition to the statutory exclusion, some courts have permitted taxpayers to exclude from income payments from a decedent's employer in excess of $5,000. The rationale of these cases is that the employer's payment to the decedent's estate or beneficiary constitutes a gift rather than compensation. Such "gifts" are excludable without regard to the $5,000 limitation.

Reasons for Change

The exclusion of certain death benefits from income creates an artificial preference for what is, in effect, an alternative form of employee compensation. The exclusion of such benefits from the tax base causes the tax rates on other compensation to increase. Moreover, the exclusion is unfair because it is not available to all taxpayers (such as self-employed individuals).

Death benefits are similar to group-term life insurance, the exclusion for which is retained. The exclusion for group-term life insurance premiums, however, is conditioned on satisfaction of certain requirements, including a nondiscrimination test. Because of the nature of death benefits, it would be very difficult administratively to place the same conditions on their availability (or on imputed premiums for death benefits, which are also excluded). In the absence of such restrictions, death benefits may become more of a vehicle to provide tax-free compensation for highly paid employees, than a means to enhance the security of employees generally.

Finally, confusion exists under present law as to whether a payment by an employer to a deceased employee's family constitutes a death benefit subject to the $5,000 limitation or a fully excludable gift. Treatment of such a payment as a gift often is contrary to economic reality and leads to different tax treatment on similar facts.

Proposal

The proposal would repeal the $5,000 exclusion for employer-provided death benefits. Any amount paid by or on behalf of an employer by reason of the death of an employee to the estate or a family member or other beneficiary of the decedent would be characterized as a taxable death benefit rather than as an excludable gift.

Effective Date

The repeal would be effective for benefits paid due to deaths occurring on or after January 1, 1986. The exclusion would continue, however, for amounts paid under a collective bargaining agreement entered into before January 1, 1986, until the earlier of January 1, 1989, or the date such agreement terminates.

Analysis

Approximately $400 million of employer-provided death benefits are excluded from income under current law. As with all exclusions, the tax benefit per dollar of the death benefit exclusion increases with the recipient's tax bracket. Thus, the exclusion provides the greatest assistance to high-income taxpayers, who are also more likely to receive such benefits than low-income taxpayers.

Finally, a specific provision that payments from an employer to a deceased employee's estate or family do not constitute gifts would simplify current law and also reduce the unfairness created by current law where similar facts may lead to different tax results.

REPEAL EXCLUSION FOR EMPLOYER-PROVIDED COMMUTING SERVICES

General Explanation

Chapter 3.03

Current Law

The value of employer-provided commuting transportation is excluded from the income of employees if the transportation services are provided under a nondiscriminatory plan using vehicles that meet size and usage requirements (generally vans). The exclusion is not available to self-employed individuals and is scheduled to expire for taxable years beginning after December 31, 1985.

Reasons for Change

The exclusion of qualified transportation services from employee income is poorly designed to promote its intended purpose of energy conservation. The exclusion targets only one form of group transportation, employer-provided van pools. This may cause taxpayers to reject possibly more efficient but non-subsidized transportation alternatives. Moreover, the qualified transportation exclusion is not aimed at ensuring security for individual employees, but rather at achieving the general goal of energy conservation. This goal can be achieved more effectively and equitably through non-tax measures.

Proposal

The exclusion from gross income of the value of employer-provided commuting transportation would be allowed to expire.

Effective Date

Taxpayers have had notice of the scheduled expiration of the van-pooling exclusion for taxable years beginning after December 31, 1985. It would be allowed to expire as scheduled.

Analysis

Expiration of the van-pooling exclusion will eliminate an unnecessary distortion in employee and employer choices over cost-effective transportation.

ESTABLISH A UNIFORM NONDISCRIMINATION RULE

General Explanation

Chapter 3.04

Current Law

Overview. A variety of fringe benefits are excluded from the income of employees if provided by employers under certain statutorily prescribed conditions. Among those conditions is the general requirement that fringe benefits be provided on a nondiscriminatory basis. Thus, with the exception of the exclusion for employer-provided health insurance, each fringe benefit exclusion is subject to nondiscrimination rules that require that the benefit not be provided on a basis that favors certain categories of employees (the prohibited group members). Failure to satisfy the applicable nondiscrimination test results in a denial of the tax exclusion, and thus inclusion of the benefit in income, either for all employees receiving the benefit or only for prohibited group members.

Separate nondiscrimination rules apply with respect to each benefit. Thus, a prohibited group member for one benefit may or may not be a prohibited group member for another benefit. Also, what constitutes impermissible discrimination and the consequences of such discrimination differ with respect to different benefits.

Group-Term Life Insurance Plans. If a group-term life insurance plan is determined to be discriminatory, the $50,000 exclusion of the cost of insurance does not apply with respect to key employees. A discriminatory plan is one which favors key employees as to eligibility to participate or as to the type or amount of benefits available under the plan. For purposes of these rules, related employers are treated as a single employer.

With respect to eligibility, a group-term life insurance plan must satisfy one of the following tests: (1) the plan benefits at least 70 percent of all employees; (2) at least 85 percent of all participants are not key employees; (3) the class of employees receiving benefits is not discriminatory in favor of key employees; or (4) in the case of a plan which is part of a cafeteria plan, the cafeteria plan requirements are met. In determining whether a plan satisfies this eligibility test, employees who have not completed three years of service, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens who receive no U.S. earned income may be disregarded.

For purposes of determining whether the type or amount of benefits under the plan discriminates in favor of key employees, all benefits available to key employees must be available to all other employees, and benefits proportionate to compensation are considered nondiscriminatory.

The term "key employee" is generally defined as it is under the top-heavy rules applicable to qualified retirement plans: officers, the top ten employee-owners, five percent owners, and one percent owners receiving at least $150,000 in annual compensation. Employees are key employees with respect to a year if they fall within one of the above categories at any time during the five preceding years.

Health Benefits Plans. The exclusion of health benefits provided by an employer through an insurance company, and the exclusion of medical benefits and reimbursements provided under such insurance, are not conditioned on the satisfaction of a nondiscrimination test. However, if an employer provides its employees with health benefits under a self-insured plan, the exclusion of a medical reimbursement under such plan is available to a highly compensated individual only to the extent the reimbursement is not an "excess reimbursement," which generally is a reimbursement provided to a highly compensated individual under a discriminatory plan.

A self-insured health plan is discriminatory if it favors highly compensated individuals as to eligibility to participate or as to benefits. For purposes of this nondiscrimination rule, related employers are treated as a single employer.

Under the eligiblity test, a health plan must benefit (1) at least 70 percent of all employees, (2) at least 80 percent of all eligible employees, but only if at least 70 percent are eligible, or (3) a class of employees that does not discriminate in favor of highly compensated individuals. In determining whether a plan satisfies any of these tests, employees who have not completed three years of service, employees who have not attained age 25, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income may be disregarded.

The benefits provided under a self-insured health plan will be treated as discriminatory unless all benefits provided for participants who are highly compensated individuals are provided for all other participants.

For purposes of these rules, highly compensated individuals are (1) the five highest paid officers, (2) shareholders owning more than ten percent of the stock of the employer, and (3) employees who are among the highest paid 25 percent of employees (excluding non-participants who may be disregarded for purposes of the eligibility test).

Group Legal Services Plans. The exclusion for contributions to or services provided under an employer-maintained group legal services plan is available to employees only if (1) the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders, self-employed individuals, or highly compensated, and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees. In determining whether a plan benefits a nondiscriminatory classification of employees, employees covered by a collective bargaining agreement may be disregarded. In addition, the availability of the exclusion is subject to a concentration test under which no more than 25 percent of the amounts contributed during a year may be provided for five percent owners (or their spouses or dependents).

Educational Assistance Programs. The exclusion for amounts paid or expenses incurred by the employer for educational assistance to an employee under an educational assistance program is not available if the program benefits a class of employees that is discriminatory in favor or employees who are officers, owners, or highly compensated (or their dependents). Under this test, employees covered by a collective bargaining agreement may be disregarded. Also, the exclusion is subject to a concentration test under which no more than five percent of the amounts paid or incurred by the employer for educational assistance may be provided for five percent owners (or their spouses or dependents).

Dependent Care Assistance Programs. The exclusion for amounts paid or incurred by the employer for dependent care assistance under a dependent care assistance program is not available unless (1) the program benefits a class of employees that does not discriminate in favor of employees who are officers, owners, or highly compensated (or their dependents), and (2) the contributions or benefits provided under the plan do not discriminate in favor of such employees. In determining whether a program benefits a nondiscriminatory classification of employees, employees covered by a collective bargaining agreement may be disregarded. In addition, under the applicable concentration test, the exclusion is not available if more than 25 percent of the amounts paid or incurred by the employer for dependent care assistance is provided for five percent owners (or their spouses or dependents).

Cafeteria Plans. The cafeteria plan exception to the constructive receipt rules does not apply to any benefit provided under the plan if the plan discriminates in favor of highly compensated individuals as to eligibility to participate or as to contributions and benefits. For purposes of these rules, related employers are treated as a single employer.

A cafeteria plan does not discriminate as to eligibility to participate if (1) the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated, and (2) there is a uniform year of service requirement of no more than three years.

A cafeteria plan will not be considered to discriminate as to contributions and benefits if statutory nontaxable benefits and total benefits (or employer contributions allocable to statutory nontaxable benefits and employer contributions for total benefits) do not discriminate in favor of highly compensated participants. If a cafeteria plan provides health benefits, the plan will not be treated as discriminatory if the following tests are met: (1) contributions on behalf of each participant include either 100 percent of the cost of health benefit coverage of the majority of highly compensated participants who are similarly situated or 75 percent of the cost of health benefit coverage of the similarly situated participant with the highest cost health benefit coverage under the plan; and (2) contributions or benefits with respect to other benefits under the plan bear a uniform relationship to compensation. If a cafeteria plan is maintained pursuant to a collective bargaining agreement, the plan is deemed to be nondiscriminatory.

A participant or individual is considered highly compensated for purposes of the cafeteria plan rules if he or she is an officer, a five percent shareholder, highly compensated, or a spouse or dependent of any of the above.

In addition, the availability of the cafeteria plan treatment for to key employees is subject to a concentration test, which provides that no more than 25 percent of the aggregate of the statutory nontaxable benefits provided to all employees under the plan may be provided to key employees. Related employers are treated as a single employer for purposes of this rule. The term "key employee" has the meaning given to such term for purposes of the top-heavy rules applicable to qualified retirement plans: officers, the top ten employee-owners, five percent owners, and one percent owners with at least $150,000 in compensation.

Certain Fringe Benefits (Sec. 132). The exclusion of a no-additional-cost service or a qualified employee discount applies to a fringe benefit provided to an officer, owner, or highly compensated employee only if such fringe benefit is available on substantially the same terms to each member of a class of employees which does not discriminate in favor of such owners, officers or highly compensated employees. Meals provided at a company cafeteria that covers its direct operating costs are generally excluded from income, except that this general exclusion does not apply to employees who are officers, owners, or highly compensated if access to the cafeteria is provided on a basis which discriminates in favor of such employees. For purposes of these rules, related employers are treated as a single employer.

Qualified Tuition Reductions. The exclusion of a qualified tuition reduction applies to an officer, owner, or highly compensated employee only if such reduction is available on substantially the same terms to each member of a class of employees that does not discriminate in favor of employees who are officers, owners, or highly compensated.

Welfare Benefit Funds. A voluntary employees' beneficiary association or a group legal services fund which is part of an employer plan is not exempt from taxation unless the plan of which the association or fund is a part meets certain nondiscrimination rules. Under these rules, no class of benefits may be provided to a class of employees that is discriminatory in favor of highly compensated employees. In addition, with respect to each class of benefits, the benefits may not discriminate in favor of highly compensated employees. A life insurance, disability, severance pay, or supplemental unemployment compensation benefit will not fail the benefit test merely because benefits are proportional to compensation. For purposes of these rules, related employers are treated as a single employer.

For purposes of the above rules, the following employees may be disregarded: (1) employees with less than three years of service; (2) employees who have not attained age 21; (3) seasonal or less than half-time employees; (4) employees covered by a collective bargaining agreement; and (5) nonresident aliens with no U.S. earned income. Under a special rule, if a benefit, such as group legal services, is covered by a separate nondiscrimination rule, that separate rule will apply in lieu of the rules described above.

The term "highly compensated individual" includes any individual who is one of the five highest paid officers, a ten percent shareholder, or among the highest paid ten percent of all employees. For purposes of determining the highest paid ten percent of all employees, employees that have not completed three years of service, employees who have not attained age 25, part-time and seasonal employees, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income may be disregarded.

These nondiscrimination rules also apply for certain other purposes. For example, they must be satisfied in order for an employer to be able to deduct contributions to a welfare benefit fund to provide post-retirement life insurance or health benefits. Also, post-retirement life insurance or a post-retirement health benefit provided through a welfare benefit fund will be subject to a 100 percent excise tax if the plan of which the fund is a part does not satisfy these nondiscrimination rules.

Reasons for Change

Nondiscrimination requirements are an integral part of the current provisions under which certain employer-provided fringe benefits are excluded from the income of employees. The tax-favored treatment of such fringe benefits significantly reduces the Federal income tax base and thus forces significantly higher marginal tax rates on wages, dividends, rents, and all other income not exempt from tax. These costs may be justified only if employer-provided fringe benefits fulfill important social policy objectives, and in this respect meet responsibilities that would otherwise fall to government and government-funded programs. Strict nondiscrimination rules are a necessary adjunct to this public policy rationale since they require that fringe benefits be nontaxable only where provided to a broad cross-section of employees. Nontaxable fringe benefits that favor key or highly compensated employees do not serve public policy objectives, but are instead a form of tax-preferred compensation for a limited class of employees.

The nondiscrimination rules that currently apply to fringe benefits are marred by inconsistency and by their failure to establish clear and administrable standards. The separate nondiscrimination rules applicable to each fringe benefit employ different definitions of the prohibited group members and establish different standards for nondiscriminatory coverage. These differences have no policy justification, and thus create unnecessary complexity for taxpayers and for the Internal Revenue Service. In addition, although employer-provided health insurance is among the most significant fringe benefits both in terms of its importance to employees and its revenue cost, it is not subject to nondiscrimination rules. As with other fringe benefits, the exclusion of such insurance from employees' income should be conditioned on its nondiscriminatory provision to a broad cross-section of employees.

The current nondiscrimination rules also provide inadequate guidance to taxpayers and to the Internal Revenue Service. Thus, the definition of prohibited group members is generally vague, leaving unclear, for example, who qualifies as an "officer," "owner," or "highly compensated employee." Similarly, little specific guidance is provided as to whether a particular pattern of coverage discriminates in favor of prohibited group members.

The uncertainty with respect to the current nondiscrimination requirements has resulted in significantly different patterns of coverage for different employee groups. Cautious employers may adopt conservative plans, covering a broad cross-section of their employees. Other employers, however, may conclude that uncertainty in the law permits an agressive approach, and set up plans that focus benefits on management or highly compensated employees. The Internal Revenue Service's ability to monitor employer practice is limited under current law, since the facts and circumstances approach of the existing standards requires that compliance be tested through detailed examination of individual cases.

The uncertainty and gaps in coverage that are attributable to the current nondiscrimination rules outweigh the arguable benefits of those rules. A facts and circumstances approach does offer flexibility to employers, but similar benefits can be achieved without wholly abandoning workable, objective standards. Objective nondiscrimination tests, if combined with a procedure under which plans involving special circumstances could be reviewed by the Internal Revenue Service, would provide workable guidelines while retaining appropriate employer flexibility.

Proposals

Scope. The nondiscrimination rules described in the following paragraph would apply to employer-maintained group-term life insurance plans, health benefit plans (whether self-insured or through an insurance company), qualified group legal services plans (whether self-insured or through an insurance company), educational assistance programs, dependent care assistance programs, cafeteria plans, certain fringe benefits (sec. 132), qualified tuition reduction arrangements, and welfare benefit funds.

Prohibited Group Members. A uniform definition of prohibited group members would apply to the nondiscrimination test for each fringe benefit. Thus, in determining whether a fringe benefit is provided on a nondiscriminatory basis in a particular year, the prohibited group members would be defined to include any employee who, at any time during the three-year period ending on the last day of the plan year, met any one of the following descriptions: (1) an owner of one percent or more of the employer (under appropriate attribution rules); (2) an employee receiving at least $50,000 in annual compensation; (3) an employee who is among the top ten percent of employees by compensation or is among the highest three employees (this number would be adjusted for small employers) by compensation, but not if he or she receives less than $20,000 in annual compensation (former employees would be disregarded for this purpose); and (4) a family member of another prohibited group member for the year. The $50,000 and $20,000 figures would be indexed for inflation.

The appropriateness of the top ten percent and highest three employees portions of the prohibited group definition in identifying the prohibited group members will depend, in part, on an employer's salary structure. Thus, a mechanical rule would be provided to identify those situations where the ten percent and high three classes of employees are inappropriate and to expand or contract these classes accordingly. Also, adjustments to the three year lookback rule may be appropriate where the number of employees employed by the employer changes significantly during that three year period.

In the case of a benefit plan that covers former employees, an employee who was a prohibited group member for either the plan year in which he separated from service or the previous plan year would continue to be treated as a prohibited group member. Thus, if an employee falls within one of the descriptions set forth above at any time within the year of separation or any of the preceding three years, he or she would continue to be a prohibited group member in the year of separation from service and thereafter. Appropriate rules would be designed to address the situation where an employee returns to service after separation.

Nondiscriminatory Coverage. The exclusion from income of each employer-provided benefit would be subject to a nondiscriminatory coverage test requiring that the percentage of prohibited group members actually benefiting under a benefit plan not exceed 125 percent of the percentage of the other employees actually benefiting under the plan. In applying this test to contributory plans, only employees making the required contribution would be treated as actually benefiting under the plan.

In certain very limited situations, where compelling business reasons indicate that application of the 125 percent test would not be appropriate, such test would not be applied if a timely ruling is obtained from the Internal Revenue Service. For example, an employer may acquire another company during a plan year. The acquired company may not have provided its employees with a health plan or it may have provided a plan substantially different from that provided by the acquiring employer. It may thus be appropriate to treat both the acquiring employer's health plan and the acquired company's health plan, if they each satisfied the coverage test prior to the acquisition, as satisfying the coverage test for a limited period after the acquisition, in order to permit the post-acquisition employer to redesign the plans to satisfy the test. Of course, during the limited period, the acquiring company's plan would be required to satisfy any reasonable conditions that the Internal Revenue Service may impose as part of the timely ruling, such as that the plan satisfy the nondiscriminatory coverage test by reference to the entire post-acquisition company with a more liberal percentage (e.g., 150 percent) substituted for 125 percent. Relief from the 125 percent test may also be appropriate where a substantial number of an employer's employees do not elect health coverage under the employer's plan because they are receiving health benefits through, for example, their spouses' employers. The Internal Revenue Service would apply reasonable conditions on the continued validity of such rulings.

In addition, any classification of employees used by a plan for participation purposes would be required to be nondiscriminatory on its face. Thus, for example, if a plan provided that the bottom 20 percent of the non-prohibited group members by compensation were ineligible, the plan would not pass the coverage test even if the plan otherwise satisfied the 125 percent coverage test. A contributory plan or a plan that excludes a class of employees based on a bona fide job category would not be discriminatory on its face under this provision.

In addition, the coverage test is not satisfied if a requirement for benefiting under the plan is discriminatory. For example, even if the 125 percent test is satisfied, the nondiscrimination coverage test is not satisfied if any non-prohibited group participant was required, as a condition of plan participation, to have completed a longer period of service than the prohibited group participant with the shortest required service period. Another example would be where any non-prohibited group participant had to make a larger employee contribution than the prohibited group participant with the smallest required contribution.

Certain classes of employees would be disregarded in applying the 125 percent coverage test to an employer's benefit plan so long as the plan did not benefit any employee in such class. The classes of excludable employees would be as follows: (1) employees with less than one year of service (except in the case of an employer's health plan); (2) part-time and seasonal employees; (3) employees covered by a collective bargaining agreement; and (4) nonresident aliens who receive no U.S. earned income. Part-time employees would generally be defined as employees who in a week work less than the lesser of (i) 20 hours or (ii) one-half of the customary hours worked by full-time employees. Seasonal employees would generally be defined as employees who in a year work less than the lesser of (i) 1,000 hours or (ii) one-half of the customary hours worked by full-time employees. In the case of an employer-maintained health plan, in lieu of the one year of service rule, employees with less than 30 days of service would be disregarded. However, employees with less than 90 days of service would be disregarded in applying the 125 percent test to a health plan if the plan also provided the option of post-separation health coverage of at least 90 days under the same terms available to other plan participants.

Nondiscriminatory Availability. All types and levels of benefits available to any prohibited group participant in a plan must also be available to all non-prohibited group participants. Similarly, if the plan applies a condition on the receipt of any type or level of benefit by any non-prohibited group participant, the same condition must apply to all prohibited group participants. For example, if a non-prohibited group participant was required to spend $1,000 on dependent care before the participant was eligible to receive reimbursements for dependent care expenses and not every prohibited group participant was subject to the same condition, the plan would discriminate in availability.

Nondiscriminatory Benefits: Insurance-Type Benefits. Group-term life insurance, health benefits, and group legal benefits provided under employer-maintained plans would each be subject to a nondiscriminatory benefits test. Health benefits and group legal benefits would both be treated as insurance-type benefits, regardless of whether they are provided under an arrangement with an insurance company or on a self-insured basis. The definition of an employer-maintained plan would be modified to require a permanent, enforceable plan to qualify for a benefit exclusion.

For group-term life insurance, benefits would be treated as nondiscriminatory if the amount of insurance coverage provided to participants varies uniformly by compensation. Thus, no prohibited group participant would be permitted to receive coverage which is a higher multiple of compensation than the lowest such multiple for any non-prohibited group participant. Appropriate rules would establish how former employees would be treated under this test.

For employer-maintained health benefit plans, including self-insured reimbursement plans, benefits would be treated as nondiscriminatory if, in all respects, the health benefit coverage provided to any prohibited group participant is also provided to all non-prohibited group participants. For this purpose, two employees actually receiving different types of health benefit coverage would be considered to have received the same type of health benefit coverage if each had the choice of electing, without charge, either type of coverage or if each had the choice of electing either type of coverage for the same charge (or for a charge which is proportional to compensation or more than proportional to compensation). Also, if two employees receive the same type of individual health coverage and only one receives family health coverage in addition, the two employees will be deemed to receive the same health coverage if the family coverage was available to both employees without charge.

In the case of health plans under which there are different levels or types of health benefit coverage, each separate level or type of health coverage must be tested as a separate plan under both the nondiscriminatory coverage test and this nondiscriminatory benefits requirement. This rule would have special application to health plans offering both individual coverage and family coverage. These two types of coverage could be considered separate benefits and thus could be tested separately under the nondiscriminatory coverage and the nondiscriminatory benefits test. However, in determining whether a separate "family coverage health plan" is nondiscriminatory under the coverage test, only employees with spouses or dependents would be considered.

Appropriate integration rules would be applied where benefits provided under Medicare or other Federal, State, or foreign law, are properly taken into account under the employer's health benefit plan. In addition, health benefits provided under a plan to an employee may be coordinated with those provided under a plan maintained by the employer of an employee's spouse.

Disability coverage would be tested under the same nondiscriminatory benefit rules applicable to other health benefit coverage, except that the amount of the coverage would be permitted to vary with compensation in accordance with the rules applicable to group-term life insurance. Also, appropriate rules would be applied for disability plans that integrate with disability benefits provided under Social Security or other Federal, State, or foreign law. If a disability plan is integrated with disability benefits under Social Security or any other law, appropriate adjustments would also be required to the extent a qualified plan maintained by the same employer may be integrated with Social Security or such other law.

An employer's group legal plan would generally have to meet the nondiscriminatory benefits test applicable to health benefit plans. Thus, a group legal plan could not discriminate with respect to legal services coverage. However, family coverage and individual coverage may not be considered the same coverage as under the health plan rules. In addition, in determining whether a separate "family coverage plan" is nondiscriminatory under the coverage test, all nonexcludable employees would be considered, regardless of family status. As with health plans, the nondiscriminatory benefits test would be applied on a per capita basis. Also, if the legal services plan provides different types or levels of legal services coverage, each type or level of benefits must be tested as a separate plan under both the nondiscriminatory coverage test and this nondiscriminatory benefits test.

As noted above, a plan would not qualify for an exclusion unless it is permanent. This means that an employer must establish the plan with the intention of maintaining it for an indefinite period of time. An early termination without a bona fide and unforeseeable business reason may indicate that the plan was not intended to be permanent, especially if the duration of certain life, health, or legal coverage coincides with the period during which one or more prohibited group participants have a need for such coverage.

Nondiscriminatory Benefits: Noninsurance-Type Benefits. An educational assistance program and a dependent care assistance program, as well as certain other fringe benefits (sec. 132) and qualified tuition reductions, would each be required to satisfy a nondiscriminatory benefits test under which the average amount provided for a prohibited group participant under the program may not exceed 125 percent of the average amount expended for a non-prohibited group participant.

In the case of educational assistance, only educational assistance expenditures for degree programs, whether they be post-graduate, college, high school, or a lower level, would be considered under the usage test. With respect to no-additional-cost services, qualified employee discounts, and qualified tuition reductions, a similar 125 percent test would be applied under which use of a service, discount, or reduction would be valued under appropriate rules.

Concentration Test. The current law concentration tests for group legal services, cafeteria plans, educational assistance, and dependent care would be retained with certain modifications. Instead of prohibiting concentration in favor of five percent owners or key employees, the rule would apply to the top twenty prohibited group members by compensation. (Appropriate rules would be provided for determining the top twenty prohibited group members by compensation.) Also, the contributions provided for prohibited group participants with respect to each of these benefits may not exceed 25 percent of the total contributions provided with respect to such benefit. In addition, the concentration test would apply to each fringe benefit excluded from income. Finally, as applied to educational assistance, the rule would be modified to apply only to education leading to a degree.

Former Employees. The nondiscriminatory coverage and benefit requirements and the concentration test would apply to former employees. However, former employees must be treated separately for purposes of these requirements. For example, if an employer provides health insurance to active and retired employees, the discrimination rules must be applied separately to the two groups.

Less Than Full-Time Employees. If an employee covered under a benefit plan works in a plan year less than the lesser of (i) 1,500 hours or (ii) 75 percent of the hours considered full-time, appropriate adjustments may be made in applying the nondiscriminatory availability and benefits tests. For example, if an employer maintains a contributory health plan, it may not be inappropriate to treat as nondiscriminatory under the availability and benefits tests a requirement that employees working less than 1,500 hours contribute a higher amount than the full-time employees.

Aggregation of Plans. For purposes of the nondiscriminatory availability and the nondiscriminatory benefits tests, employer plans covering a common prohibited group participant shall be treated as one plan unless each of the plans would satisfy the nondiscriminatory coverage test if 100 percent were substituted for 125 percent. Also, at the election of the employer, two or more plans of such employer may be treated as one plan.

Effect of a Finding of Discrimination. If a plan is discriminatory in coverage or benefits, or fails to satisfy the concentration test, the exclusion would not apply to prohibited group participants. In the case of group-term life insurance, health benefits, and group legal services, the exclusion of the value of the coverage under the plan would not apply. If the coverage under the plan were taxable to the prohibited group participants, however, any reimbursement of expenses under the plan would remain nontaxable. A finding of discrimination would not affect the exclusion of the coverage for non-prohibited group participants.

In the case where a prohibited group member participates in a discriminatory health benefit plan and a nondiscriminatory health benefit plan, the amounts taxable under the discriminatory plan would not reduce the amounts taxable under the nondiscriminatory plan. See Ch. 3.01 for a discussion of the amounts taxable under a nondiscriminatory plan.

Cafeteria Plans. The nondiscrimination tests applicable to a particular benefit, as described above, would continue to apply to such benefit even if it is offered under a cafeteria plan.

In addition, the cafeteria plan must satisfy the nondiscriminatory coverage test treating each employee eligible to make elections under the plan as benefiting under the plan. Also, the nondiscriminatory availability test would apply to a cafeteria plan. Thus, all types and levels of benefits available to any prohibited group participant must also be available to all non-prohibited group participants, and if the plan applies a condition on the receipt of any type or level of benefit by any non-prohibited group participant, the same condition must apply to all prohibited group participants.

In applying the nondiscriminatory coverage and benefits tests to each separate benefit offered under a cafeteria plan, a special rule would apply to reimbursements of medical, legal, or dependent care expenses under a reimbursement account. A reimbursement account for either medical, legal, or dependent care expenses would be deemed to satisfy the nondiscriminatory coverage and benefits tests if the average reimbursement for prohibited group participants in the cafeteria plan does not exceed 125 percent of the average reimbursement for non-prohibited group participants in the cafeteria plan. In applying this test, reimbursements for medical, legal, and dependent care expenses would be aggregated. A reimbursement account would generally be defined as an arrangement maintained by the employer which is funded in whole out of elective contributions by participants. Reimbursements of insurance premiums would not be permitted under reimbursement accounts. The current law rules otherwise applicable to reimbursement accounts (e.g., forfeitability) would continue to apply.

For purposes of testing each individual benefit under the nondiscriminatory coverage and benefits tests, each level or type of benefit elected under the cafeteria plan would be treated as a separate plan.

Welfare Benefit Funds. The nondiscrimination rules applicable to welfare benefit funds would be modified to conform to the proposed nondiscrimination rules. Thus, for example, a voluntary employees' beneficiary association would be precluded from discriminating in favor of those employees who are prohibited group members under the proposed definition. In addition, the 125 percent coverage test would apply.

Aggregation of Employers. The rules treating related employers as a single employer for purposes of the rules described in this proposal would be extended to each fringe benefit. Also, the leasing rules currently applicable to qualified plans would apply without regard to the safe harbor plan provisions of such rules.

Effective Date

The proposal would generally apply to fringe benefit plan years beginning on or after January 1, 1986. However, this general effective date would be January 1, 1987 with respect to employer-provided health care coverage. In addition, an exception would be made for fringe benefit plans maintained pursuant to a collective bargaining agreement entered into prior to January 1, 1986, until the first plan year beginning on or after the earlier of January 1, 1989 or the date such agreement terminates.

Analysis

The extension and strengthening of the nondiscrimination rules would help direct more of the benefits to those for whom the exclusions were designed. The coverage test, for instance, would assure that in most situations, non-prohibited group members would be covered in proportions close to that of the prohibited group members. For example, assume an employer has 20 prohibited group members and 80 non-prohibited group members and none of these employees may be excluded from the nondiscriminatory coverage test. Assume further that all of the prohibited group members are covered. In order to satisfy the 125 percent coverage test, at least 80 percent of the non-prohibited group members, i.e., 64 of the non-prohibited group members, must be covered.

REPEAL EXCLUSION FOR EMPLOYEE AWARDS

General Explanation

Chapter 3.05

Current Law

Gifts are excluded from the gross income of the donee. Whether an employer's award to an employee constitutes taxable compensation or a gift excludable from gross income depends upon the facts and circumstances surrounding the award.

If an employee award is excludable from income as a gift, the amount that can be deducted by the employer is limited by statute. In general, the cost of a gift of an item of tangible personal property awarded to an employee by reason of length of service, productivity or safety achievement may not be deducted by the employer to the extent that it exceeds $400. In the case of an award made under a permanent, written plan which does not discriminate in favor of officers, shareholders, or highly compensated employees, gifts of items with a cost up to $1,600 may be deducted, provided that the average cost of all items awarded under all such plans of the employer does not exceed $400.

The fact that an award does not exceed the dollar limitations on deductions has no bearing on whether the award constitutes taxable compensation to the employee; in all cases that issue depends on the facts and circumstances surrounding the award. Nevertheless, many taxpayers take the position that if the dollar limitations are not exceeded, the award automatically constitutes a gift and is excludable from the employee's income.

Reasons for Change

A gift for tax purposes is a transfer of property or money attributable to detached and disinterested generosity, motivated by affection, respect, admiration, or charity. The on-going business relationship between an employer and employee is generally inconsistent with the disinterest necessary to establish a gift for tax purposes. Moreover, in the unusual circumstances where an employee award truly has no business motivation, it should not be deductible as an ordinary and necessary expense of the employer's business.

Current law not only allows employee awards to be characterized as gifts but provides a tax incentive for such characterization. The amount of an employee award treated as a gift is excluded from the income of the employee, but the employer may nevertheless deduct the award to the extent it does not exceed certain dollar limits. Even to the extent an award exceeds those limits, gift characterization produces a net tax advantage if the employee's marginal tax rate exceeds that of the employer.

Current law also generates substantial administrative costs and complexity by requiring the characterization of employee awards to turn on the facts and circumstances of each particular case. The dedication of Internal Revenue Service and taxpayer resources to this issue is inappropriate, since relatively few employee awards represent true gifts and since the amounts involved are frequently not substantial.

Proposal

Gift treatment would generally be denied for all employee awards. Such awards would ordinarily be treated as taxable compensation, but in appropriate circumstances would also be subject to dividend or other non-gift characterization. De minimis awards of tangible personal property would be excludable by the employee under rules of current law concerning de minimis fringe benefits.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Available data concerning employee awards of tangible personal property is incomplete. Surveys indicate that businesses made gifts to employees totalling approximately $400 million in 1983. It is unclear what portion of these gifts were in the form of tangible personal property; however, the majority of these gifts were less than $25 in value. Less than ten percent of all employees are covered by an employer plan for such benefits. Thus, the proposal would affect few employees and would promote horizontal equity.